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SENSITIVE

DEPT FOR EAP/MTS AND EB/IFD/OMA
TREASURY FOR IA-BAUKOL
COMMERCE FOR 4430/GOLIKE
DEPARTMENT PASS FEDERAL RESERVE SAN FRANCISCO- FINEMAN
DEPARTMENT PASS EXIM BANK

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SUBJECT: INDONESIA - AUDIT FIRM ROTATION RULE HURTS BUSINESS CLIMATE

¶1. (SBU) Summary: Indonesia is one the few countries in the world requiring companies to appoint a new auditor every five years, a practice known as Audit Firm Rotation. The practice of rotating individuals, or Audit Partner Rotation, is widespread across the globe. Accounting firms and their clients uniformly criticize the GOI's requirement for audit firm rotation as unfriendly to business. Our industry contacts told us they hope to amend draft legislation, which will soon be before Parliament, to abolish the firm rotation requirement. They said they have requested that Trade Minister Pangestu and Vice President Kalla intervene on their behalf. Audit rotation may also create complications for U.S. firms with Indonesian subsidiaries. End Summary.

Background: Audit Firm Rotation

¶2. (U) Many oversight bodies around the globe have expressed concern that an accounting firm responsible for auditing the financial statements of a company for too many years will lead to a decline in audit quality. An auditor can become too close to the company, grow stale from repetition, or fall prey to pressure to retain the client. Many audit firms counter that a long term relationship improves the audit. Many accountants and regulators say the best way around possible conflicts of interest is to rotate the audit partner every few years, while leaving the audit firm in place. That way, the individual who has the final authority regarding decisions on accounting positions taken by the client changes, but institutional knowledge of the client is carried forward by the other accountants who remain. Audit firms are partnerships, not corporations. It generally takes over a decade to reach partner, at which time one is required to buy-in to the partnership. If a court finds an audit firm liable for audit mistakes, it is possible that the partnership could go bust and the partners will have nothing. Thus, audit partners tend to take the responsibility seriously.

Indonesia Requires Firm Rotation

¶3. (SBU) We met with auditors from two of the local "Big 4" accounting firms, retired auditors, the president of the Indonesian Institute of Accountants (known by its Indonesian acronym IAI), and obtained position papers from local business chambers. The regulation requiring audit firm rotation is based on the 2002

Ministry of Finance (MOF) Decree No. 423/KMK.06/2002 and a draft Public Accountants Law. Companies are currently operating under the decree which requires audit partner rotation after three years and audit firm rotation after five years. This is a requirement for all companies subject to audit, even if not listed on the stock exchange. The proposed law requires both partner and firm rotation at the five-year mark. The proposed law may go to parliament next year. Additionally for listed companies in Indonesia, Capital Market Supervisory Agency (BAPEPAM) decree No. 20/2002 regarding the Independence of Accountants providing Audit Services in the Capital Market includes a five year audit firm rotation cycle rule. Our contacts tell us the Ministry of Finance made the audit firm rotation requirements without fully consulting IAI or local industry.

Local Auditors' Reaction:
Inefficiency and Complexity

¶4. (SBU) The accountants we spoke with were universally against the audit firm rotation requirement. It does not enhance independence or improve audit quality, but actually increases cost and reduces quality, they argued. They said they accepted formalized audit partner rotation, since personnel rotate naturally on an engagement due to promotions, retirements, and reassignments. An audit partner at one of the "Big 4" said it takes three years just to become fully functioning. Indonesian firms can also be complex, with far-flung branches and multi-layered structures. An effective audit requires institutional knowledge: continuity allows the auditor to see year-to-year changes and adjust audit risk accordingly. All of this is lost if the audit firm is capriciously replaced, our contacts said.

¶5. (SBU) Partners at another "Big 4" audit firm stated that the Indonesian rules took auditing to another level beyond the much maligned U.S. Sarbanes Oxley Act, by increasing complexity for both the audit firm and the client. They said the audit firm rotation time frames appeared arbitrary and felt that there was insufficient dialogue between the MOF and auditing industry. They also echoed the comments on the loss of efficiency.

Local Business Chamber Reaction:
Restriction of Free Market

¶6. (SBU) The International Business Chamber (IBC), the European Business Chamber (Eurocham), and the Accounting Department at the University of Indonesia wrote to various ministries (Finance, Trade, and Justice) in December 2006 and February 2007 regarding the draft public accountants law. Minister of Trade Mari Pangestu responded to the IBC in March 2007 that, "All relevant parties and stakeholders should sit down together and discuss the draft law." The business chambers also raised the point that Indonesian company law specifically gives shareholders the right to appointing auditors of an Indonesian company. Mandatory audit firm rotation undermines this right of the shareholders and restricts the free market in audit services, they said.

Indonesian Institute of Accountants:
Raising Issue to the Vice President

¶7. (SBU) The President of the IAI Ahmadi Hadibroto said Audit Firm Rotation has more disadvantages than benefits. He said the IAI has protested the requirement since its inception. Hadibroto said that the audit firm rotation requirement in the Ministerial Decree appeared without warning. Prior versions of the draft law discussed between MOF and IAI made no mention of audit firm rotation requirements. Hadibroto also said that multiple MOF officials with overlapping oversight roles and a lingering suspicion of auditors since the financial crisis have led to four years of deadlock in seeking to overturn the requirement.

¶8. (SBU) The IAI had approached Vice President Jusuf Kalla in late

May about the problems it is having with the decree and the MOF. Kalla appeared sympathetic to the IAI's concerns, according to Hadibroto, but only asked that IAI to send him a letter with details for discussion. Hadibroto is optimistic that the IAI still has time to beat back the audit firm rotation requirement since the draft law will probably not go to Parliament this year.

Getting Around the Rules

¶9. (SBU) Like many regulations in Indonesia, the MOF decree has a loophole that allows an audit firm to continue to audit the same client in spite of the rotation requirement. An audit firm simply needs to change its name and alter the partner composition so that the new firm has more than 50% new partners. Additionally, the registered Indonesian name is what has to change. If a firm is part of a global network, the brand name does not have to change, only the local name. The audit partners at global firms dismissed such reorganizations as unnecessary complications. However, they told us that some firms are beginning to do complex reorganizations to continue with their clients. Two or three partners firms cannot easily reorganize, however, leading to audit fieldwork performed by one firm but signed off by another to get around the rules.

¶10. (SBU) Hadibroto noted that it is now almost five years since the five-year audit firm rotation requirement went into force, so the decree will soon affect audit firms directly. However, he said that many mergers and reorganizations took place on paper in the aftermath of the decree's implementation. Thus, the same faces, albeit under a new audit firm name, will continue to audit the same company even as the five-year mark arrives.

Indonesia in a Small Club

¶11. (U) Only Indonesia and Italy require audit firm rotation in a strict sense. Spain and Turkey adopted audit firm rotation requirements, but subsequently dropped them. South Korea and Singapore started to require audit firm rotation, but Singapore dropped the idea to extend audit rotation to other industries after negative experiences in the banking sector, and South Korea granted exemption for companies with overseas shareholders or where the company is listed on a foreign stock exchange. In Italy, Bocconi University studied audit firm rotation and found that it is "detrimental to audit quality, but does seem to have a positive effect on improving public confidence in the corporate sector" according to the New York State Society of CPAs. The U.S. Securities and Exchange Commission (SEC) requires that companies subject to the Sarbanes Oxley Act rotate lead and concurring audit partners every five years, with other significant audit partners required to rotate after seven years.

Conclusion: Audit Sector Struggling

¶12. (SBU) The outlook for the health of the auditing sector in Indonesia is not positive. Our industry contacts tell us they hope that the firm rotation requirement is removed from the draft law before the law goes before parliament. They wish to avoid extended debate with parliamentarians who may not know much about accounting and want to appear that they are standing up to big business. Compounding their woes, our contacts say fewer Indonesian university graduates chose to go into accounting with each passing year. Auditors told us that in the last ten years only 500 new Indonesian Certified Public Accountants received their licenses. Furthermore, the IAI states that 50% of licensed accountants in Indonesia are over 50 years old. These circumstances will create a shortage of qualified accountants within a decade.

¶13. (SBU) U.S. companies with Indonesian subsidiaries should also take note. The auditor for these companies is usually the same around the world. If the U.S. company's Indonesian subsidiary is not large enough to be material to the companies operations, the U.S. headquarters is usually unconcerned with who audits the company

in Indonesia. However, if the Indonesian subsidiary is material to the financial reporting of the U.S. firm and the local auditor changes to a firm beyond the control of the global auditor, U.S. headquarters may face additional audit fees for the global auditor to revisit the work of the Indonesian auditor. If the audit firm rotation requirement does become law, it will create a negative impact on audit quality, transparency and business competitiveness in Indonesia.

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